



Signed: October 24, 2005

*Leslie Tchaikovsky*

LESLIE TCHAIKOVSKY  
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT  
NORTHERN DISTRICT OF CALIFORNIA

In re  
HAROLD WAYNE HUTSON, etc.,  
Debtor.

No. 04-41779 TG  
Chapter 13

CITY OF VALLEJO,

A.P. No. 05-4253 AT

Plaintiff,

vs.

HAROLD WAYNE HUTSON, etc.,  
et al.,

Defendant.

**MEMORANDUM OF DECISION RE CITY OF VALLEJO'S FEE APPLICATION**

The City of Vallejo (the "City") filed an application for attorneys' fees and costs in connection with the above-captioned adversary proceeding. Defendants Insurance Company of the West and Explorer Insurance Company (the "Sureties") filed an opposition to the Application. For the reasons stated below, the application is denied.

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## SUMMARY OF FACTS AND CONTENTIONS

Prior to the commencement of this bankruptcy case, the City contracted with the Debtor to perform a work of improvement and required the Debtor to provide the City with one or more payment and/or performance bonds (the "Bonds"). The Sureties are the issuers of the Bonds.

In October 2003, before the work of improvement was completed, one of the Debtor's subcontractors, Thomas & Pratt Highway Specialty Services, Inc. ("Thomas & Pratt"), served a stop notice on the City in the amount of \$22,060 (the "First Stop Notice"). Later that month, Thomas & Pratt served a second stop notice on the City in the amount of \$42,950.27 (the "Second Stop Notice"). After the Second Stop Notice was served, the Sureties provided the City with a release bond (the "Release Bond") in the amount of \$64,425.40, and the funds then due were released to the Debtor.<sup>1</sup>

The Debtor completed the project, and the City accepted the work on March 30, 2004. On April 1, 2004, the Debtor filed a chapter 13 petition. At that time, the City still owed the Debtor \$20,548.12 in retention funds (the "Retention Funds"). After the bankruptcy filing, on April 13, 2004, Thomas & Pratt wrote a letter to the City, complaining that it had not yet been paid. On April 14, 2004, a representative of one of the Sureties wrote to

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<sup>1</sup>Additional stop notices (the "Additional Stop Notices") were served on the City by other subcontractors in March 2004. On January 10, 2005, the City was provided with release bonds with respect to the Additional Stop Notices.

1 the City, demanding that the City place a freeze on the Retention  
2 Funds.

3 On August 23, 2004, Thomas & Pratt wrote the City again,  
4 demanding payment of the amount due from the Debtor and  
5 threatening to sue the City if payment was not received. On  
6 August 30, 2004, an attorney representing the City spoke by  
7 telephone with the representative of one of the Sureties. The  
8 representative of the Sureties demanded that the City release the  
9 Retention Funds to them. On January 10, 2005, in the letter  
10 enclosing a release bond for the Additional Stop Notices, the  
11 representative continued to assert the Sureties' right to the  
12 Retention Funds.

13 On April 16, 2005, the City filed an action in state court,  
14 seeking to interplead the Retention Funds and naming the Trustee,  
15 the Sureties, and Thomas & Pratt as defendants. On April 20,  
16 2005, the Trustee's attorney wrote to the City, making a formal  
17 demand for turnover of the Retention Funds to the Trustee pursuant  
18 to 11 U.S.C. §§ 541 and 542. The attorney advised the City that  
19 it had violated the automatic stay of 11 U.S.C. § 362 by filing  
20 the state court interpleader action. He also advised the City  
21 that it had improperly sued the Trustee without first seeking  
22 permission of the court that appointed the Trustee: i.e., the  
23 bankruptcy court. He cited authority for this principle. See In  
24 re Kashani, 190 B.R. 875, 885 (Bankr. 9<sup>th</sup> Cir. 1995) and Leonard v.  
25 Vrooman, 383 F.2d 556, 560 (9<sup>th</sup> Cir. 1967. Finally, he asserted  
26 that any action against the Trustee should have been filed in the

1 bankruptcy court. He asked the City to dismiss the state court  
2 interpleader action immediately.

3 The City failed to turn over the Retention Funds to the  
4 Trustee at that time.<sup>2</sup> It did dismiss the state court interpleader  
5 action. However, it then filed the Interpleader Action without  
6 first seeking the Court's permission. The City then filed an  
7 application, seeking payment of its attorneys' fees and costs for  
8 filing the Interpleader Action. The Sureties opposed the  
9 application on the ground that it was unnecessary for either of  
10 interpleader actions to be filed.

#### 11 **DECISION**

12 When a bankruptcy case is filed, an estate is created. With  
13 limited exceptions, not applicable here, the estate consists of  
14 all of the debtor's property on the petition date. See 11 U.S.C.  
15 § 541. Property of the estate includes property encumbered by  
16 liens or against which the claims of third parties may be  
17 asserted. Absent an order of the bankruptcy court to the  
18 contrary, the trustee is entitled to possession of property of  
19 the estate. For that reason, 11 U.S.C. § 542 requires any party  
20 in possession of property of the estate when a bankruptcy petition  
21 is filed, other than a custodian, to deliver the property to the  
22 trustee. The City does not qualify as a custodian.

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26 <sup>2</sup>Ultimately, the City did turn over the Retention Funds to  
the Trustee and the Sureties' claim to the funds has apparently  
been resolved without judicial intervention.

1           Delivery of property subject to liens or against which claims  
2 may be asserted does not deprive the secured creditors or  
3 unsecured claimants of their rights. Those rights must simply be  
4 asserted in the bankruptcy case. The City acted improperly by  
5 failing to deliver the Retention Funds to the Trustee promptly  
6 once it learned of the bankruptcy case and, in any event, after  
7 turnover was demanded by the Trustee's attorney.

8           The City contended that it filed the interpleader actions  
9 based on threats of litigation made by Thomas & Pratt in April and  
10 August 2004. This contention is not credible. The state court  
11 interpleader was not filed until April 2005. What is credible is  
12 that the City viewed the Sureties and the Trustee's demands for  
13 turnover of the Retention Funds as conflicting claims, justifying  
14 the filing of an interpleader action. This was a misconception.  
15 As noted above, federal bankruptcy law gives the Trustee the right  
16 to possession of the funds. That right does not conflict with the  
17 Sureties' right to assert a claim to the funds in the bankruptcy  
18 court. In fact, both Thomas & Pratt's and the Sureties' attempts  
19 to persuade the City to turn over the Retention Funds to them  
20 constituted a violation of the automatic stay. See 11 U.S.C. §  
21 362(a)(1) & (3). They did not justify the filing of an  
22 interpleader action.

23           Since the City acted improperly by filing the Interpleader  
24 Action, its fee application will be denied. Counsel for the  
25 Sureties is directed to submit a proposed form of order in  
26 accordance with this decision.

END OF DOCUMENT

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